OPEN MEETING ITEM

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ARIZONA CORPORATION COMMISSION

DATE: JANUARY 30, 2007

DOCKET NO: WS-03478A-05-0801

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Teena Wolfe. The recommendation has been filed in the form of an Opinion and Order on:

FAR WEST WATER AND SEWER COMPANY
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

FEBRUARY 8, 2007

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

FEBRUARY 13, 2007 and FEBRUARY 14, 2007

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF FAR WEST WATER AND SEWER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR SEWER UTILITY SERVICE BASED THEREON.	DOCKET NO. WS-03478A-05-0801 DECISION NO. ____________ **OPINION AND ORDER**

DATES OF HEARING:	April 7, 2006 (public comment), July 14, 2006 (pre-hearing conference), July 18, 19, and 20, 2006
PLACE OF HEARING:	Yuma, Arizona (public comment), and Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Teena Wolfe
APPEARANCES:	Jay Shapiro, FENNEMORE CRAIG, PC, on behalf of Far West Water and Sewer Company; Daniel Pozefsky, Attorney, on behalf of the Residential Utility Consumer Office; and Keith Layton, Staff Attorney, Legal Division, on behalf of the Commission's Utilities Division.

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BY THE COMMISSION:

I. INTRODUCTION

On November 1, 2005, Far West Water and Sewer Company ("Far West" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for an increase in its rates for sewer utility services.

Far West is a public service corporation engaged in providing water and sewer utility services to the public in Yuma, Arizona. Far West provides sewer utility services to approximately 5,500 customers in Yuma. This is the first time that the Company has requested an increase in its sewer utility rates. Far West currently charges the rates and charges set on April 8, 1998 in Decision No. 60799, which authorized the transfer of the Certificate of Convenience and Necessity ("CC&N") held by H&S Developers, Inc. dba Far West Water Company and Far West Sewer Company to Far West.[1]

A. Procedural History

By Procedural Order issued December 20, 2005, a hearing was set in this matter to commence on July 11, 2006. The hearing was continued to July 18, 2006 at the Company's request by Procedural Order issued January 17, 2006, and the timeclock for a final Commission Decision was extended accordingly.

Intervention was requested by and granted to the Residential Utility Consumer Office ("RUCO"). No other parties sought intervention in this matter.

On March 8, 2006, the Company docketed an affidavit certifying that a copy of the notice required by the January 17, 2006 Procedural Order was mailed to each of the Company's sewer customers on February 8, 2006.

Following notification of the Company's rate application, several customers contacted the Commission and expressed an interest in participating in Commission proceedings on the application. Accordingly, a public comment hearing was scheduled to take place in Yuma to allow customers who wished to appear and provide public comment for the record to do so without the necessity of

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[1] In compliance with the requirement of Decision No. 60437 (September 29, 1997) that the water division of H&S Developers, Inc. dba Far West Water Company and Far West Sewer Company be operated separately from its parent corporation with separate accounts, H&S Developers, Inc. dba Far West Water Company and Far West Sewer Company requested the transfer of assets and CC&N to the newly-formed Far West Water and Sewer Company.

traveling to the Commission's Phoenix offices. The public comment hearing was held on April 7, 2006 in Yuma as scheduled, and numerous customers appeared and provided public comment on the rate application.

A full evidentiary hearing was held on the application as scheduled commencing on July 18, 2006 and continuing on July 19 and 20, 2006.

The Company, RUCO and the Commission's Utilities Division Staff ("Staff") appeared at the hearing and presented evidence before an Administrative Law Judge of the Commission. Following post-hearing filings, which included final schedules and initial and reply briefs filed by the parties, and a November 13, 2006 Notice of Filing by the Company providing a copy of a Consent Order executed by the Arizona Department of Environmental Quality ("ADEQ") and the Company regarding the Company's wastewater treatment facilities, this matter was taken under advisement.

B. Rate Application

As stated above, Far West currently charges the rates and charges set on April 8, 1998 in Decision No. 60799, which authorized the CC&N transfer to Far West. The current rate application, which is the first rate application the Company has filed for its sewer utility services, is based on a test year ended December 31, 2004. The Company is requesting an increase in revenues of $433,577, for an increase of 29.64 percent over test year adjusted revenues of ($79,006), for a total revenue requirement of $1,900,786. RUCO is recommending an increase in revenues of $200,839, or 13.73 percent, from test year adjusted revenues of $15,406, for a total revenue requirement of $1,663,831. Staff is recommending a revenue increase of $205,384, or 14.04 percent over test year adjusted revenues of ($28,725), for a total revenue requirement of $1,668,376. Based on adjustments to the Company's filing as set forth herein, we authorize an increase in revenues of $205,384, which is a 14.04 percent increase over test year adjusted revenues of $1,462,992, for a total revenue requirement of $1,668,376.

II. RATE BASE

The Company proposes an adjusted test year Original Cost Rate Base ("OCRB") of $1,816,530. Staff proposes an adjusted test year OCRB of $1,549,650. RUCO proposes an adjusted test year OCRB of $1,813,561.

A. Plant in Service

The Company proposes adjusted test year plant in service of $12,071,013. Staff recommends $11,931,781, and RUCO recommends $12,810,199.

1. Affiliate Profits and Overhead

H&S Developers, Inc. ("H&S") formed Far West as a separate entity pursuant to Commission direction in Decision No. 60437. Staff expressed concern in this proceeding regarding transactions between Far West and its affiliate H&S. H&S billed Far West for certain capital projects from 2000 until 2004 (Direct Testimony of Crystal S. Brown, Exh. S-22 at 13, 16-18). In response to Staff's position that $916,784 of plant costs recorded in Far West's general ledger were unsupported by source documentation, Far West agreed to removal of the costs from plant in service (*See* Rejoinder Testimony of Thomas J. Bourassa, Exh. A-6 at 4).

Staff recommends that capitalized affiliate overhead and profit in the amount of $147,545 also be excluded from plant in service. Staff testified that H&S recorded this amount in its general ledger as construction costs plus 18.5 percent of "gross profit" (Surrebuttal Testimony of Crystal S. Brown, Exh. S-23 at 9). The Company disagrees with Staff's recommendation and claims that approximately $110,000 of the $147,525 is comprised of overhead incurred by H&S (Exh. A-6 at 7). Staff asserts that the Company has not demonstrated that the affiliate transactions were arm's-length, and that the profits should therefore not be allowed in plant in service. Staff further asserts that the Company has not supported its assertion regarding the claimed overhead amounts with source documentation (*See* Tr. at 567-569), and testified that H&S informed Staff that it does not keep detailed job costing records for its overhead (Exh. S-23 at 11 (quoting a data response from the Company)). Staff also argues that the costs the Company claims to be overhead do not fit the definition of "Overhead Construction Costs" in the NARUC USOA[2] (*Id.* at 8-9, 11).

a. Discussion

The Company contends that it has affirmatively met its burden of showing that the total costs of the affiliate transactions were reasonable, and that once it has made such an affirmative showing,

[2] National Association of Regulatory Commissioners' Uniform System of Accounts.

the costs cannot be disallowed absent evidence showing why the payments made to H&S were not reasonable (Company Br. at 5-6). Far West states that the 18.5 percent billed by H&S over labor and materials costs represents H&S' embedded costs of salaries and payroll, medical insurance, workers' comp, office rent, telephone and utilities that H&S incurs to maintain a business that is available to do construction jobs for Far West and any other person wishing to hire a construction company (Co. Br. at 6). Far West argues that it provided all of the labor, material and equipment rates charged by H&S and presented evidence of comparable costs charged by two other local firms and the RSMeans cost data handbook; that H&S competes in the Yuma market and undertakes construction projects for non-affiliated entities; and that the amounts charged by H&S are at or below market (Company Br. at 7). Staff contends that allowing the capitalized affiliate profits in plant in service in this case is unreasonable, because requests for proposals were not issued for the construction work and because services between Far West and H&S may or may not have written contracts. Staff points out that H&S is Far West's sole shareholder, and although the companies are separate legal entities, they share common shareholders, directors and officers. Staff argues that Far West did not produce evidence establishing market prices for each and every year in which affiliate transactions occurred in order to demonstrate that the project costs were reasonable, and that while the projects in question were completed in the years 2000 through 2004, quotes provided by the Company were dated 2004, 2005 and 2006. Staff further argues that no supporting bids for the projects were supplied, and that the Company provided no evidence of costs H&S may have charged non-affiliates.

b. <u>Conclusion</u>

A.A.C. R14-2-601(D)(1) requires sewer utilities to maintain accounting records for specific plant necessary to give complete and authentic information as to its properties. Although the Company provided general arguments that the 18.5 percent profit billed to it by H&S represent H&S' embedded costs, the record reflects that the Company failed to provide source documentation for its claim that $110,000 of the capitalized affiliate overhead and profit in the amount of $147,545 on the H&S general ledger represents overhead costs. The Company failed to meet the burden of producing supporting documentation for the Company's claimed overhead costs. Because the Company failed to adequately support its claim that the $110,000 represented H&S' overhead costs, it would be inequitable to include this amount in plant in service for ratemaking purposes.

Likewise, we find that the record does not reflect an adequate showing from the Company that the $37,545 affiliate profit was the result of arm's-length transactions, or that it reflects fair market value.[3] We therefore find that the remaining $37,545 classified on the H&S ledger as affiliate profit was not necessary to the Company's provision of utility service, and must also be disallowed in order to prevent double recovery of profit, first in the authorized rate of return on rate base, and second, in profit to the Company's sole shareholder H&S, which has the same shareholders, directors and officers as Far West. Because the purpose of these disallowances is not to punish any misconduct, it is not necessary, as the Company argues, to have a showing of misconduct in order to disallow these amounts from plant in service.

2. Conclusion

Based on the evidence presented, $13,420,251 is reasonable for test year plant in service for the Company. After subtracting the accumulated depreciation balance of $1,488,470, the test year adjusted plant in service balance is $11,931,781.

B. <u>Cash Working Capital</u>

Far West utilized the formula method to determine its requested cash working capital amount of $127,647. RUCO recommended $124,678. Staff recommends zero cash working capital, based on its position that Class B utilities such as Far West should use a lead-lag study rather than the formula method, and that pursuant to Decision No. 60437, the Company should be required to perform a lead-lag study to determine the appropriate level of working capital. Far West urges the adoption of its formula-derived cash working capital allowance, arguing that Staff did not determine a working capital allowance utilizing any method, that Decision No. 60437 did not concern the Far West's sewer division; and that Far West used the formula method in order to reduce its rate case

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[3] The Company's witness testified as follows:

"The problem that arises in the real world of construction is not only doing the work in a timely fashion but doing it efficiently. To hire an outside contractor is difficult. Probably in the future we should supply to you some supporting bids. . . . I think that would be helpful to get that information to the Commission. I think you will find it supportive of H&S Developers, but you are right, it probably is a little hard to discern that information. It's just - - the demand on the city of Yuma right now is incredible. But I don't think it's unreasonable to give that supporting information. It's time consuming to do it, but it's not, I don't think, an unreasonable request." (Tr. at 69.)

expense (Company Reply Br. at 6-7).

We stated in Decision No. 60437 that a lead-lag study is appropriate for a Company of Far West's size and that it "will produce a more accurate determination of the need for an Allowance for Working Capital." (Decision No. 60437 at 5.) We further stated that in the event Far West Water Company did not conduct a lead-lag study in connection with its next rate proceeding, that we would adopt a zero cash working capital component in determining rate base (Decision No. 60437 at 22). While Decision No. 60437 did not specifically order Far West to use a lead lag study if it wanted to request a cash working capital allowance in its next sewer division rate proceeding, it gave the Company actual notice of our intent to require a lead-lag study so that any need for a cash working capital allowance can be determined. For a utility the size of Far West, absent a lead-lag study, we cannot determine whether there is a need for a cash working capital allowance to determine rate base. Far West failed to meet its burden of showing that there was an actual need for a cash working capital allowance. We will therefore adopt a zero cash working capital component in this proceeding.

III. ORIGINAL COST RATE BASE

The Company's proposed adjusted test year balances for Advances in Aid of Construction ("AIAC") of $7,513,932; net Contributions in Aid of Construction ("CIAC") of $2,861,764; and customer meter deposits of $6,435 were not contested and will be adopted, for a total deduction from net plant in service of $10,382,131, resulting in an adjusted test year OCRB of $1,549,650.

IV. FAIR VALUE RATE BASE

The Company did not propose a reconstruction cost new less depreciation rate base, as is allowed by A.A.C. R14-2-103. Therefore, the Company's fair value rate base ("FVRB") is the same as its OCRB, or $1,549,650.

V. OPERATING INCOME

The Company proposed adjusted test year operating income of $(79,006). Staff calculated test year operating income to be $(28,725), and RUCO calculated $15,406 in test year operating income.

A. Rate Case Expense

The parties agree on a three-year amortization of rate case expense but disagree on the amount of recoverable expense. The Company filed an itemization of rate case expense on August 23, 2006 showing actual billings through July 2006 of $177,662.68. The Company is requesting recovery of $160,000 in rate case expense. Staff does not propose an alternative recovery amount. RUCO proposes that rate case expense recovery be limited to $70,000.

RUCO contends that the costs actually incurred by the Company in preparation for this proceeding are unreasonable. RUCO based its proposed rate case expense recovery not on the Company's costs, but instead on the amount of rate case expense awarded in the Company's prior rate proceeding for its water division. RUCO argues that the case in this proceeding is less complex than the prior proceeding, and that the amount of rate case expense awarded should therefore be half of the $120,000 in expense awarded by Decision No. 62649 (June 13, 2000), plus $10,000 in order to true up the amount to present day dollars (Direct Testimony of Rodney L. Moore, Exh. R-4 at 18; RUCO Br. at 2).

We disagree with RUCO regarding its comparison of the relative complexity of this proceeding in comparison to the case leading to Decision No. 62649. Based on the preparation required by this proceeding, we find the amount of $160,000 in recoverable rate case expense requested by the Company to be reasonable, amortized over three years.

B. <u>Repair and Maintenance Expenses</u>

Staff normalized test year repair and maintenance expenses based on its position that the test year expenses were significantly higher than for the years 2002 and 2003. Staff's proposed adjustment would result in a reduction of $43,378 from the Company's proposed test year repair and maintenance expense level (Exh. S-22 at 20). Far West opposes Staff's proposed adjustment, asserting that it does not consider the impact of customer growth (Company Br. at 16). Far West argues that Staff did not claim that any single test year invoice was abnormal or non-recurring, and claims that because Staff's adjustment does not consider 2005 post test year repair and maintenance expenses, the test year level of expense is less than the amount the Company was likely to incur on a going-forward basis (Company Reply Br. at 8).

Staff argues that its normalization of expenses is appropriate in that it takes into account increased costs due to customer growth while disallowing imprudent costs. Staff states it accounted for customer growth by calculating an average per customer cost over three years using the number of customers for each year, and then applied the resulting average customer cost to the number of customers in the test year. Staff believes that the additional expenses over the average are unreasonable and imprudent, because the Company's wastewater treatment facilities repair and maintenance problems were caused by poorly-selected engineers and contractors hired by the Company to construct the facilities (Staff Reply Br. at 11, citing Rebuttal Testimony of Company witness Mark Kaveny, Exh. A-2 at 8 ("We were railroaded by substandard, fly-by-night engineers and contractors who stuck so-called wastewater plants in the ground, collected their money, and got out of Dodge")).

Ratepayers should not be burdened with the costs of treatment system repairs necessitated by faulty system installations. We find that the amount of repair and maintenance expense proposed by Staff most accurately reflects a reasonable level of test year repair and maintenance expense, and is fair to both the Company and its ratepayers.

C. <u>Effluent Sales</u>

The Company is requesting approval in this proceeding of a tariff for effluent sales. Because the Company does not currently have an effluent tariff in place, the parties made adjustments to account for revenues from effluent sales, which has the effect of lowering the portion of the revenue requirement that residential customers will pay. The Company's $72,094 adjustment and Staff's $80,476 adjustments are based on projected effluent sales to two golf courses (Rejoinder Testimony of Thomas J. Bourassa, Exh. A-6 at 33-34, Rej. Sched. H-1; Surrebuttal Testimony of Crystal S. Brown, Sched. CSB-2). RUCO recommends that an additional $31,294 in revenues be imputed to the Company representing projected effluent sales to a third golf course, the Mesa Del Sol Golf Course (Direct Testimony of Rodney L. Moore, Exh. R-4 at 23-24, Sched. RLM-13). The Company has an existing contract with the Mesa Del Sol Golf Course under which the golf course is obligated to take and dispose of 500,000 gallons of effluent per day (Tr. at 281-284, 392). The Mesa Del Sol Golf Course is not affiliated with Far West or H&S.

The Company argues that both the Company and ratepayers benefit from the Mesa Del Sol Golf Course contract, as Far West is guaranteed not to incur any costs for disposing of the effluent the golf course has agreed to take (Company Br. at 11). RUCO disagrees that ratepayers benefit from the Company's agreement with the Mesa Del Sol Golf Course, and that failure to impute revenues will result in higher rates paid by ratepayers. The Company contends that if RUCO's adjustment were adopted and the Company were to begin charging the Mesa Del Sol Golf Course under the new tariff, the golf course might choose to use its own groundwater and stop taking the effluent, and the Company would be left without a means of recovering the imputed revenues, while possibly being burdened with disposal costs (Company Reply Br. at 11-12).

The Company's request for an effluent sales tariff is reasonable and will be granted. Due to the existing contractual agreement with the Mesa Del Sol Golf Course, and in the interest of gradualism, we will not at this time impute revenues under the tariff from the effluent which the Company is required to provide at no charge, and which that golf course is currently required to take and dispose of, under their existing contract. However, we will revisit this issue in the next rate proceeding for Far West's sewer division, and because the Company is now on notice, we may impute revenues at that time. In order to avoid such imputation it its next rate proceeding, the Company must provide a specific factual cost-benefit analysis that provides justification for treating one of the Company's golf course customers differently from its other golf course customers in the application of its effluent sales tariff.

D. <u>Property Tax Calculation</u>

RUCO argues that the Commission should reject the Company's and Staff's recommended estimates of property tax, based on the calculation methodology adopted by the Commission in prior rate proceedings, and instead accept RUCO's recommended property tax expense estimate of $48,072, which is $38,044 lower than the Company's estimate of $86,116, and $33,973 lower than Staff's estimate of $82,045. RUCO's estimate is based on a calculation methodology rejected in numerous prior rate proceedings.[4] The methodology used by the Company and Staff to estimate property tax expense, which is to use adjusted test year revenues and the projected revenues under the

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[4] *See, e.g., Black Mountain Sewer Corporation,* Decision No. 69164 (December 5, 2006); *Chaparral City Water Company*, Decision No. 68176 (September 30, 2005); *Rio Rico Utilities Co.*, Decision No. 67279 (October 5, 2004); *Arizona-American Water Company*, Decision No. 67093 (June 30, 2004); *Bella Vista Water Company*, Decision No. 65350 (November 1, 2002); *Arizona Water Company*, Decision No. 64282 (December 28, 2001).

newly approved rates as inputs to the Arizona Department of Revenue ("ADOR") assessment formula, is the same methodology adopted in numerous prior cases over the objections of RUCO. RUCO proposes, as it has previously, to instead use revenues from the test year and the two years prior to the test year to calculate property tax expense (RUCO Br. at 8). RUCO compared the results of its methodology, based on the Company's historical revenues for the test year, and the two years prior, with the results of the Commission's methodology. RUCO contends that since its methodology more accurately predicted the actual 2005 assessment, the Commission should adopt its approach on this issue (RUCO Br. at 8-9; Direct Testimony of Rodney L. Moore, Exh. R-4 at 13).

We once again disagree with RUCO's position on this issue. RUCO stated in its own testimony that the ADOR calculation that encompass the full effect of the authorized rate relief in this case will not be computed until 2010, because it is not until then that historical years 2007, 2008 and 2009 will be assessed (Exh. R-4 at 14). Consistent with numerous prior decisions, we do not believe RUCO's backward-looking methodology properly recognizes that, barring extraordinary circumstances, any increase granted in this case will increase the Company's property taxes. As we stated in the *Chaparral City* case cited above, "RUCO's calculation methodology, which uses only historical revenues, unfairly and unreasonably understates property tax expense, and is therefore inappropriate for ratemaking purposes" (Decision No. 68176, at 14). RUCO has not demonstrated a basis for departure from our prior determinations on this issue. The Company and Staff's calculation for property tax expense yields the best estimate of the Company's property tax expense for the period in which new rates will be in effect, and we will adopt it.

E. <u>Statement of Operating Income</u>

All parties agree that the Company's adjusted test year operating revenues were $1,462,992. In accordance with the discussion herein, the Company's adjusted test year operating expenses for ratemaking purposes total $1,491,717, for an adjusted test year net operating income of $(28,725).

VI. <u>COST OF CAPITAL</u>

Far West, Staff and RUCO presented cost of capital analyses for purposes of determining a fair value rate of return in this proceeding. Far West proposes a rate of return of 10.50 percent; Staff recommends 7.80 percent; and RUCO recommends 8.81 percent.

A. <u>Capital Structure and Cost of Debt</u>

1. Capital Structure

The parties disagree on the appropriate capital structure to use in determining a cost of capital return on equity for the Company. While the Company proposes a capital structure of 100 percent equity, RUCO recommends a hypothetical capital structure of 60 percent common equity and 40 percent debt, and Staff recommends a capital structure of 44 percent debt and 56 percent equity,[5] based on the Company's overall debt for its water and sewer divisions combined. Far West has incurred authorized debt in the form of a loan from the Arizona Water Infrastructure Financing Authority ("WIFA"), and has used the proceeds to construct water utility plant.

Far West advocates that a 100 percent equity capital structure should be used because there is no debt financing of its sewer utility plant; its water utility rates are not based on any plant dedicated to the provision of sewer service; it files separate annual reports for its water and sewer divisions; and Commission rules separate revenues from water and sewer sales for classification purposes.

RUCO contends that its recommended hypothetical capital structure is appropriate, and that it is actually heavier in equity than the average capital structure in the sample group its witness used in RUCO's cost of equity analysis. RUCO also contends that its hypothetical capital structure is forward-looking, given that the Company testified that it expects to file an application for approval of long-term debt financing in the immediate future (Exh. R-7, Exh. Rigsby Surrebuttal at 6).

Staff states that its recommended capital structure rejects the Company's proposal to assign all debt to its water division and recognizes both the Company's authorized debt obligations and debt to its affiliate, H&S (Exh. S-18, Irvine Direct at 10). Staff argues that the Company's recommended 100 percent equity capital structure represents a hypothetical capital structure for Far West's sewer division, and argues that the Company's financing for its water and wastewater divisions is so intertwined that use of separate capital structures is unreasonable. Staff believes that a consolidated capital structure is necessary to be fair to both water and wastewater ratepayers, because the negative

[5] Staff's final schedules filed August 15, 2006 showed a recommended capital structure of 46.5 percent debt and 53.5 percent equity. However, the final schedules provided no explanation for the change from Exh. S-25 admitted at the hearing through Staff's witness, which showed Staff's recommendation of 44 percent debt and 56 percent equity based on a change in Staff's recommended retroactive debt approval amount (*see* Tr. at 477-478).

covenants in the WIFA loan that comprises the Company's debt make it unreasonable to assign the WIFA debt to water ratepayers, but not sewer ratepayers, for determining a capital structure. The negative covenants affect whether the Company can incur new debt for its sewer division (Exh. S-10 at 16-17 (Section 11)). Staff argues that if the Company's position were adopted, it would result in sewer ratepayers incurring detriments related to the WIFA debt without receiving a benefit from it in the capital structure.

The Company argues that Staff's proposed capital structure results in a mismatch of capital structure to rate base. The Company contends that there is no basis to assume that Far West can borrow 48.1 percent of its capital needs at a 5.8 percent interest rate. The Company is also critical of RUCO's use of a hypothetical capital structure to bring the Company in line with the sample companies used in RUCO's analysis.

Staff also recommends that $571,244 of Far West's accounts payable to H&S be considered long-term debt, and that the Commission retroactively approve financing for that amount at a cost of debt of 5.93 percent, based on the actual interest paid to H&S (*See* Exh. S-26). Staff's witness testified that it based the $571,244 amount on the Company's aging schedule for this account (*See* Exh. S-24). Staff states that this treatment is appropriate because Far West held very high minimum balances in the account during the test year, which indicates that not all the balances are paid within one year (Irvine Direct at 9-10). Staff argues that because H&S and Far West are operated as a single entity, H&S should not be allowed to receive interest for accounts payable without approval, and should not be allowed to benefit by excluding Company debt from the capital structure in this case. The Company argues that Staff's recommendation to retroactively approve financing for $571,244 of Far West's accounts payable to H&S at a cost of debt of 5.93 percent, "forces" H&S to become a captive lender at an interest rate below prevailing interest rates.

As the Company's witness agreed, the concept of capital structure is a financial and accounting concept which applies to an entity as a whole (Tr. at 319-320). We find that it is necessary to recognize both the Company's authorized debt obligations and the debt to its affiliate H&S in setting an appropriate capital structure, and that given the negative covenants in the WIFA debt which affect the Company as a whole, and not just the sewer division, it would be unreasonable to assign the WIFA debt to water ratepayers, but not sewer ratepayers, in determining a capital structure. Staff's recommendation regarding financing approval is also reasonable and appropriate, based on high balances the Company held with its affiliate during the test year. The interest rate of 5.93 percent is reasonable because it is based on the actual interest paid to the affiliate. We will therefore adopt Staff's proposed capital structure of 44 percent debt and 56 percent equity for purposes of determining the Company's cost of capital in this proceeding, and will approve debt in the amount of $571,244 as recommended by Staff.

2. Cost of Debt

Staff recommends that the cost of debt be set at 5.8 percent, the interest rate on Far West's existing WIFA loan. RUCO recommends a cost of debt of 8.45 percent, which RUCO states is higher than the 6.45 percent average cost of debt in the sample of water utilities used by RUCO's cost of capital witness. We find it reasonable to set the cost of debt based on Far West's existing WIFA loan, and will adopt Staff's recommendation of 5.8 percent.

B. <u>Cost of Equity</u>

A cost of equity component must be determined in order to set a just and reasonable rate of return. Setting a cost of equity requires estimation relying on financial analysis. The parties to this case are not in full agreement as to the manner in which financial models should be used in order to reach a cost of equity estimate. The expert witnesses testifying on behalf of the Company, RUCO and Staff reached different conclusions based on their methodologies, which include the discounted cash flow ("DCF") model and the capital asset pricing model ("CAPM"). Based on the financial analysis and adjustments of its witness, the Company advocates a cost of equity of 10.5 percent. Staff advocates a cost of equity of 9.3 percent and RUCO advocates a cost of equity of 9.04 percent, based on the financial analyses of their respective witnesses.

1. Far West

The Company's witness Mr. Bourassa performed two versions of the constant growth DCF model and also a two-stage DCF model, using a sample group of six water utilities (*see, e.g.*, Exh. A-5, Bourassa Rebuttal at 22, Schedules D-4.9, D-4.10, and D-4.11), reaching a cost of equity estimate in the range of 7.7 percent to 11.5 percent. Mr. Bourassa adjusted the results of his DCF modeling using a bond-yield plus risk premium method (*id.,* Schedules D-4.12 and D-4.13), reaching a cost of equity estimate in the range of 10.2 percent to 11.3 percent. Mr. Bourassa then used a comparable earnings methodology (*id.*, Schedule D-4.14), and found the range of actual returns to range from 7.8 percent to 11.5 percent and found authorized returns to range from 9.9 percent to 12.7 percent. Finally, Mr. Bourassa considered Value Line's forecasts of the composite equity returns for the water utility industry of 10 percent for 2006, 10.5 percent for 2007, and 11.5 percent for 2009-2001. Based on this analysis, which he updated again in rejoinder testimony (*see* Exh. A-6, Bourassa Rejoinder at 17-18, Schedules D-4.9, D-4.10, D-4.11, and D.4.14), Mr. Bourassa recommends 10.5 percent as the cost of equity, cost of capital, and authorized rate of return on the Company's original cost rate base.

The Company is dissatisfied with both RUCO's and Staff's recommended cost of equity, believing they are too low, and prefers the cost of equity estimate reached by its witness. The Company argues that the results of Staff's DCF modeling produces indicated costs of equity below the cost of debt (*see* Exh. A-5 at 65), and that past total market returns are greater than any of the parties' recommendations (*see* Exh. A-5 at 29, 57, Exh. A-6, Bourassa Rejoinder at 29). Far West also contends that the methodology Staff used to reach its recommendation is flawed, because Staff's recommended cost of equity in this case is the same as that Staff recommended in other cases in 2003, although interest rates and the risk free rate have risen significantly since 2003 (*see* Company Closing Br. at 19). Far West provided a table in its Closing Brief entitled "Comparison of Key Cost of Capital Determinants and Staff Cost of Equity Model Results" which includes the average beta, risk-free interest rate, and Staff's recommended cost of equity in prior water utility rate cases before this Commission (*id.* at 18). Far West also argues that it is a riskier enterprise than the large public utilities the parties used as samples in their analyses, such that an upward adjustment to the cost of equity must be made to take the additional risk into account (*see* Exh. A-4 at 24-26, Exh. A-5 at 42-43).

2. RUCO

RUCO's witness Mr. Rigsby performed a DCF constant growth analysis and a CAPM analysis. Mr. Rigsby applied his models to three of the companies in the same sample group of six water utilities Mr. Bourassa used, and to an additional water company not used by Mr. Bourassa. Mr.

Rigsby also used eight natural gas distribution companies as a proxy for Far West in his DCF and CAPM analyses.

Mr. Rigsby's recommendation for a cost of equity of 9.04 percent is based on the result of his DCF model using his sample water companies (Exh. R-6, Rigsby Direct at 33; Exh. R-7 at 3-4, Exh. R-7, Schedules WAR-1-9). Mr. Rigsby also considered the current economic environment in reaching his cost of equity recommendation (*see* Exh. R-6 at 33-47, Exh. R-7, Schedule WAR-8). RUCO believes that its recommended 9.04 percent cost of common equity is appropriate given the current environment of relatively low inflation and historically low interest rates. RUCO disagrees with the Company's contention that it is subject to extraordinary risk because of its size and the environment in which it operates. RUCO argues that its unadjusted 9.04 percent cost of equity recommendation already accounts for any unique business risk that the Company may face because as a whole, RUCO's sample companies used in its DCF analysis had riskier capital structures (approximately 50 percent equity) in comparison to RUCO's recommended hypothetical 60 percent equity/40 percent debt capital structure.

3. Staff

In determining its recommended cost of equity, Staff's cost of capital witness Mr. Irvine used the constant growth DCF model, the multi-stage DCF model and the CAPM. Mr. Irvine prepared two CAPM estimates, one using a historical market risk premium, and one using a current market risk premium. Staff's witness then averaged the results of his DCF model results, and also averaged his CAPM results (Exh. S-25, Schedule SPI-2). By averaging the DCF average with the CAPM average, Mr. Irvine reached his recommended cost of equity estimate of 9.3 percent (*Id.)*.

4. Discussion

Upon review of the analyses and testimony presented by the cost of capital witnesses in this proceeding, it is apparent that the most realistic cost of equity, supported by the weight of the evidence, is that proposed by Staff. Staff's recommendation is based on proven financial models and on balanced, reasonable inputs. Staff's CAPM analysis includes both a historical and a current market risk premium to mitigate market volatility, and Staff's DCF methodology gave equal weight to historical and projected earnings per share, dividends per share, and sustainable growth, based on available market data. While Far West criticizes the results of Staff's DCF modeling because some of the growth rates Staff used produce some indicated costs of equity below the cost of debt, it does not criticize Staff's use of the highest growth rates that produce some higher indicated costs of equity. We agree with Staff's argument that it would be inappropriate to exclude inputs that produce results that are viewed as either too low or too high based on a comparison to a chosen benchmark.

We are not convinced by Far West's argument that Staff's methodology is flawed because interest rates and the risk free rate have risen significantly since 2003, but that Staff's recommended cost of equity has not increased from Staff recommendations in 2003. As Staff points out, Far West's argument ignores the effect of the market risk premium. The table of past cost of equity recommendations appearing in Far West's brief is incomplete in that it does not include market risk premiums, the necessary third input in the CAPM model, and their effect. Neither do we accept Far West's argument that due to its small size, the Company has more risk than the sample companies used in the parties DCF and CAPM analyses, and that such risk justifies Far West's requested upward adjustment to the cost of equity in this proceeding. As we have previously found, small firm size does not provide a reasonable basis for a risk premium adjustment.

The 9.3 percent cost of equity recommended by Staff based on its analysis as presented by the evidence in this proceeding is appropriate and results in a just and reasonable return for Far West.

We therefore adopt a cost of equity of 9.3 percent, which results in an overall weighted cost of capital of 7.8 percent.

C. Cost of Capital Summary

	Percentage	Cost	Weighted Cost
Long-Term Debt	44.0 %	5.8 %	2.6%
Common Equity	56.0 %	9.3 %	5.2 %
Weighted Average Cost of Capital			7.8 %

VII. AUTHORIZED INCREASE

With the adjustments adopted herein, the Company's adjusted test year operating income is $(28,725). Applying the fair value rate of return of 7.8 percent to the Company's FVRB of $1,549,650 produces a required operating income of $120,873. This is $149,597 more than the adjusted test year operating income under existing rates. The required increase in gross annual revenues for the Company is $205,384, for a 14.04 percent increase over test year adjusted revenues.[6]

VIII. OTHER ISSUES

A. Health and Safety Compliance and Environmental Compliance

On October of 2001, a tragic incident occurred in which a Far West employee collapsed and died of asphyxiation while entering a sewer collection tank to deflate a stopper in a gravity line, and a contractor's employee who entered the tank to rescue the Far West employee also died. At the time of the incident, Far West had no written confined space entry policy or program. Today, Far West has a written confined space entry program that exceeds that required by the Occupational Safety and Health Administration ("OSHA"), and has instituted classroom and field training for its confined space program.

Staff recommends that the Company continue with its current process for maintaining health and safety compliance, and that it be required to file each January and July a report covering the previous six months that contains the following:

1. The name and grade level of each operator;
2. The type of training offered to Far West employees;
3. The name of each employee attending the above trainings;
4. The number and type of OSHA reportable violations, if any.

Staff also recommends that Far West's operators, agents, and employees, including employees and agents of contractors or subcontractors operating or constructing the Far West wastewater facilities, be required to comply with all Arizona Division of Occupational Safety and Health ("ADOSH") requirements including any and all training required by ADOSH to operate wastewater facilities. Staff also recommends that the Company be required to review with ADOSH a fire incident at the Palm Shadows Treatment Facility that occurred on May 15, 2006, and which the Company did not report to ADOSH because it determined that the incident was not reportable to ADOSH (Tr. at 144-145).

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[6] Using a revenue conversion factor of 1.37291.

Staff further recommends that Far West, on an annual basis, on the anniversary date of this Decision, for a period of three years, be required to file with Docket Control, as a compliance item in this docket, certification from ADOSH that it has availed itself of ADOSH consultation services and that its operators, agents and employees, including employees and agents of contractors or subcontractors operating or constructing the Far West wastewater facilities, have taken appropriate training.

The Company states that it accepts responsibility for its current compliance issues as well as responsibility to resolve them completely and as quickly as reasonably possible (Company Reply Br. at 21). The Company further states that it accepts Staff's recommendations at the hearing concerning health and safety.

Staff's recommendations are reasonable and we will adopt them.

B. Future Plant Improvement/Costs

The Company states that it has faced a number of operation difficulties that have resulted in customer complaints over odors and several instances of non-compliance with ADEQ.[7] The Company's witnesses testified that these difficulties generally resulted from rapid growth, inadequate performance by independent contractors, and the failure of the Company's previous management team to take adequate action to meet the demands of customers. At the hearing, the Company presented testimony that it plans to install state-of-the-art bio membrane treatment technology to treat wastewater flows, which it expects to produce a higher quality effluent, and to conduct a system-wide review of odor control issues (Rejoinder Testimony of Gary M. Lee, Exh. A-3 at 2-2). The Company states that it believes that all measures that can be taken to remedy every concern over its wastewater treatment system are being taken at this time. Staff recommended that any increase in rates and charges approved in this proceeding not become effective until the first day of the month following the date the Company has filed in this docket a copy of an executed consent order with ADEQ for all of the wastewater systems that are out of ADEQ compliance, and the Company accepted Staff's recommendation. On November 13, 2006, the Company filed a copy of a Consent Order executed by

[7] During the public comment hearing held in Yuma on April 7, 2006, most of the comments from customers were in regard to offensive sewer odor.

the Company and ADEQ regarding the Company's Seasons, Section 1, Palm Shadows, Villa Royale, Del Rey, Del Oro and Marwood wastewater treatment plants. With the execution of the Consent Order, all of Far West's wastewater treatment facilities are currently subject to a Consent Order with ADEQ.

Staff recommends that the Company attempt to identify damages from contractors who the Company's witness testified did not meet their obligations and caused the Company to incur ADEQ violations, and that the Commission closely scrutinize plant additions in the Company's next rate case to ensure that the Company is not seeking recovery of costs to fix problems caused by prior contractors. Staff further recommends that the Company should be required to account for plant retrofit costs separately from plant expansion costs in its next rate proceeding. We concur with Staff's recommendations and will adopt them, so that ratepayers will not pay for duplicate plant costs.

C. Depreciation Rates

Staff recommends that the Company be required to use the depreciation rates set forth in Table G-1 appearing on page 21 of Hearing Exhibit S-19 by individual NARUC category on a going-forward basis. The Company does not object. Staff's recommendation is reasonable and will be adopted.

* * * * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. On November 1, 2005, Far West filed with the Commission an application for an increase in its rates for sewer utility services.

2. On November 22, 2005, RUCO requested intervention, which was granted by Procedural Order issued December 2, 2005. No other requests for intervention were filed.

3. A Procedural Order was issued on December 20, 2005, setting a hearing and setting associated procedural and filing deadlines.

4. By Procedural Order issued January 17, 2006, the hearing was continued to July 18,

2006 at the Company's request, and the timeclock for a final Commission Decision was extended accordingly.

5. On March 8, 2006, the Company docketed an affidavit certifying that a copy of the notice required by the January 17, 2006 Procedural Order was mailed to each of the Company's sewer customers on February 8, 2006.

6. A public comment hearing was held in Yuma, Arizona on April 7, 2006. Many members of the public appeared at the public comment hearing and provided public comment on the application.

7. A hearing was held as scheduled before a duly authorized Administrative Law Judge of the Commission on July 18, 19, and 20, 2006. The Company, RUCO and Staff appeared and presented evidence.

8. On August 15, 2006, the Company filed its post-hearing schedules. Staff also filed its post-hearing schedules on August 15, 2006. The Company filed an itemization of its rate case expense as a supplement to its final rate schedules on August 23, 2006, and RUCO filed its post-hearing schedules on August 29, 2006

9. On September 8, 2006, the parties filed closing briefs.

10. On September 29, 2006, the parties jointly filed a Stipulation Extending Time to File Reply Briefs.

11. By Procedural Order issued October 3, 2006, the deadline for filing Reply Briefs was extended by two weeks to October 13, 2006.

12. On October 11, 2006, the Company filed a Request for Extension of Time to File Reply Briefs. The Request stated that counsel for the Company received concurrence of Staff and RUCO for the extension, and that the Company agreed to any necessary extension of the timeclock rules arising out of the request.

13. By Procedural Order issued October 12, 2006, the deadline for filing Reply Briefs was extended to October 18, 2006.

14. On November 13, 2006, the Company filed a copy of a Consent Order executed by the Company and ADEQ regarding the Company's Seasons, Section 1, Palm Shadows, Villa Royale, Del

Rey, Del Oro and Marwood wastewater treatment plants.

15. On November 27, 2006, a Procedural Order was issued extending the timeclock in this matter due to the extension of time for filing reply briefs.

16. Based on the adjusted test year data, as determined herein, the operating income under existing rates is $(28,725).

17. Based on the adjusted test year data, as determined herein, the FVRB is $1,549,650.

18. A fair and reasonable fair value rate of return is 7.80 percent.

19. The increase proposed by Far West would produce an excessive return on FVRB.

20. The authorized increase in gross annual revenues is $205,384.

21. The rates proposed by the Company would produce an increase in annual revenues of 29.64 percent which would result in a monthly rate increase from $20.00 to $24.87, or 24.35 percent, for residential customers.

22. The rates set herein produce an increase in annual revenues of 14.04 percent which results in a monthly rate increase from $20.00 to $21.75, or 8.75 percent, for residential customers.

23. The Company has no outstanding compliance issues with the Commission.

24. Far West should be required to continue with its current process for maintaining health and safety compliance, and to file with Docket Control, as a compliance item in this docket each January and July a report covering the previous six months that contains: 1) The name and grade level of each operator; 2) The type of training offered to Far West employees; 3) The name of each employee attending the above trainings; and 4) The number and type of OSHA reportable violations, if any.

25. Far West should be ordered to require all its operators, agents, and employees, including employees and agents of contractors or subcontractors operating or constructing the Far West Water and Sewer Company wastewater facilities, to comply with all Arizona Division of Occupational Safety and Health requirements including any and all training required by ADOSH to operate wastewater facilities.

26. Far West should be required to review with ADOSH the fire incident that occurred on May 15, 2006 at the Palm Shadows Treatment Facility.

27. Far West should be required to file with Docket Control on an annual basis, on the anniversary date of this Decision, for a period of three years, as a compliance item in this docket, certification from ADOSH that it has availed itself of ADOSH consultation services and that its operators, agents and employees, including employees and agents of contractors or subcontractors operating or constructing the Far West Water and Sewer Company wastewater facilities have taken appropriate training.

28. Far West should be required to attempt to identify damages from contractors whose failure to meet contractual obligations led to Far West's ADEQ violations, and should be required to document those attempts.

29. Far West should be required to document, and in its next sewer division rate proceeding, to account for wastewater plant retrofit costs separately from expansion costs in order to allow the Commission to ensure that costs to remedy problems caused by prior contractors who did not meet their obligations are not included in rate base twice.

30. Far West should be required to use the depreciation rates set forth in Table G-1 appearing on page 21 of Hearing Exhibit S-19 by individual NARUC category on a going-forward basis.

31. Because an allowance for the property tax expense of the Company is included in the Company's rates and will be collected from its customers, the Commission seeks assurances from the Company that any taxes collected from ratepayers have been remitted to the appropriate taxing authority. It has come to the Commission's attention that a number of companies have been unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers, some for as many as twenty years. It is reasonable, therefore, that as a preventive measure Arizona-American annually file, as part of its annual report, an affidavit with the Utilities Division attesting that the Company is current in paying its property taxes in Arizona.

CONCLUSIONS OF LAW

1. Far West Water and Sewer Company is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. Sections 40-301, 40-302, 40-241, and 40-250.

2. The Commission has jurisdiction over the Company and the subject matter of the application.

3. Notice of the application was provided in the manner prescribed by law.

4. The long-term financing approved herein is for lawful purposes within Far West's corporate powers, is compatible with the public interest, with sound financial practices, and with the proper performance by Far West of service as a public service corporation, and will not impair Far West's ability to perform that service.

5. The rates and charges approved herein are just and reasonable.

ORDER

IT IS THEREFORE ORDERED that Far West Water and Sewer Company is hereby directed to file with the Commission on or before February 28, 2007, revised schedules of rates and charges consistent with the schedule set forth below and the discussion herein:

	Rates
Residential Service – Per month	$21.75
RV Parks – Per month, per space	5.44
Commercial – Per month	43.50
Effluent Sales – Per 1,000 gallons	1.00
SERVICE CHARGES:	
Establishment	$20.00
Re-establishment (Within 12 Months)	(a)
Reconnection (Delinquent)	20.00
Minimum Deposit (Residential)	(b)
Minimum Deposit (Non-Residential)	(b)
Deposit Interest	(b)
NSF Check Charge	$15.00
Deferred Payment Finance Charge Per Month	1.50%
Late Payment Charge	1.50%
Main Extension Tariff (b)	Cost
Service Line Connection	Cost

(a) Minimum charge times number of full months disconnected.

(b) Per A.A.C. R14-2-603B: Residential – two times average bill
Non-Residential – two and one-half times average bill

IT IS FURTHER ORDERED that the revised schedule of rates and charges shall be effective for all service rendered on and after March 1, 2007.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall notify its affected customers of the revised schedules of rates and charges authorized herein by means of an insert in its next regularly scheduled billing in a form and manner acceptable to the Commission's Utilities Division Staff.

IT IS FURTHER ORDERED that financing is hereby approved for Far West Water and Sewer Company's debt to H&S Developers, Inc. in the amount of $571,244 at an interest rate of 5.93 percent.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall continue with its current process for maintaining health and safety compliance, and that it shall file with Docket Control, as a compliance item in this docket each January and July a report covering the previous six months that contains: 1) The name and grade level of each operator; 2) The type of training offered to Far West employees; 3) The name of each employee attending the above trainings; and 4) The number and type of OSHA reportable violations, if any.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall require all its operators, agents, and employees, including employees and agents of contractors or subcontractors operating or constructing the Far West Water and Sewer Company wastewater facilities to comply with all Arizona Division of Occupational Safety and Health requirements including any and all training required by the Arizona Division of Occupational Safety and Health to operate wastewater facilities.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall review with ADOSH a fire incident that occurred on May 15, 2006 at the Palm Shadows Treatment Facility.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall, on an annual basis, on the anniversary date of this Decision, for a period of three years, file with Docket Control, as a compliance item in this docket, certification from the Arizona Division of Occupational Safety and Health that it has availed itself of the Arizona Division of Occupational Safety and Health consultation services and that its operators, agents and employees, including employees and agents of contractors or subcontractors operating or constructing the Far West Water and Sewer Company wastewater facilities have taken appropriate training.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall attempt to identify damages from contractors whose failure to meet contractual obligations led to Far West Water and Sewer Company's ADEQ violations, and shall document those attempts.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall document, and in its next sewer division rate proceeding, shall account for wastewater plant retrofit costs separately from expansion costs in order to allow the Commission to ensure that costs to remedy problems caused by prior contractors who did not meet their obligations are not included in rate base twice.

IT IS FURTHER ORDERED that Far West Water and Sewer Company shall use the depreciation rates set forth in Table G-1 appearing on page 21 of Hearing Exhibit S-19 by individual NARUC category on a going-forward basis.

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IT IS FURTHER ORDERED that Far West Water and Sewer Company shall annually file as part of its annual report, an affidavit with the Utilities Division attesting that the Company is current in paying its property taxes in Arizona.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _____ day of _________, 2007.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT ________________________

DISSENT ________________________

SERVICE LIST FOR: FAR WEST WATER AND SEWER COMPANY

DOCKET NO.: WS-03478A-05-0801

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